

There have also been a series of federal and state audits that have uncovered a variety of cross subsidies and overcharges:

- Pacific Bell has continued to fund its enhanced services, as well as other competitive ventures, with ratepayer revenues. The CPUC permitted Pacific Telesis Group to spin off its wireless service operations to an independent company only on condition that Pacific's ratepayers be reimbursed \$7.9 million for their funding of development costs.^{78/} Similar problems were revealed in a CPUC audit released last summer and in an audit of BellSouth released at the same time.^{79/} Previously, audit teams conducting combined FCC/state joint audits of the BOCs had complained that most of the BOCs had stalled the progress of the audits through slow responses to data requests and cited, in particular, BellSouth's "consistent pattern of obstructionist behavior."^{80/}
- A Common Carrier Bureau audit, released in October 1993, of the affiliate transactions between BellSouth's operating companies and a nonregulated subsidiary revealed overcharges by the affiliate of \$25.7 million, resulting in overcharges to interstate ratepayers of \$6 million.^{81/}
- A Common Carrier Bureau audit of transactions between the GTE Telephone Operating Companies (GTOCs) and two nonregulated affiliates revealed overcharges of the GTOCs by the affiliates, which were passed on by the GTOCs to their ratepayers. The GTOCs entered into a Consent Decree requiring a common line rate reduction of

^{78/} Interim Opinion, Investigation on the Commission's own motion into the Pacific Telesis Group's "spin-off" proposal, I. 93-02-028, Decision 93-11-011 (CPUC Nov. 3, 1993), mod. on other grounds, Decision 94-03-036 (CPUC March 9, 1994).

^{79/} Bell Audits Find Common Problems, NARUC Told, Telecommunications Reports, August 1, 1994, at 13.

^{80/} Joint Audits of SW Bell, Ameritech, Pacific Telesis Near End; Controversies Continue to Stall BellSouth, NYNEX Reviews, Telecommunications Reports, April 4, 1994, at 7-8.

^{81/} See BellSouth Affiliate Transaction Audit: Summary of Audit Findings and attached BellSouth Statement, BellSouth Corporation, BellSouth Telecommunications, Inc., AAD 93-127 (Nov. 8, 1993).

\$49.5 million.^{82/}

- A joint five-state/FCC audit of Southwestern Bell affiliate transactions and cost allocations among Southwestern Bell's operating company and its affiliates revealed overcharges by the affiliates totalling \$93.7 million for the period 1989-92, which have burdened Southwestern Bell's intra- and interstate ratepayers.^{83/}

MCI believes, as it did at the time of the Computer III Remand proceeding, that cost allocation rules are inherently ineffective, no matter how many bells and whistles are added to the process. As MCI explained in its Comments in that docket, such rules cannot work because: there is no accurate method for developing an allocator for jointly used resources; LEC control over allocation formulae and the internal data used to populate the formulae result in the distorted apportionment of costs; and BOCs will continue to overproject their regulated use of joint investment and expenses, rendering any forward-based allocation incorrect.^{84/} Cost accounting rules also do not work because

^{82/} Consent Decree Order, The GTE Telephone Operating Companies, AAD 94-35 (released April 8, 1994).

^{83/} Five States Regulatory Commissions and Federal Communications Commission Joint Audit Team, Review of Affiliate Transactions at Southwestern Bell Telephone Company (May 1994).

^{84/} The lack of any real control over such projections is epitomized by the Commission's laughably limp warning to the LECs in the Video Dialtone Order that it "would not anticipate accepting a 0% allocation of overhead" to video dialtone service in applying the new services test. Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, Telephone Company - Cable Television Cross-Ownership Rules, Sections 63.54-63.58 and Amendments of Parts 32, 36, 61, 64 and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service, CC Docket No. 87-266, FCC 94-269 (released Nov. 7, 1994) at ¶ 220.

there is no effective deterrent to violations. If and when a violation happens to be uncovered by an audit years later, the competitive and ratepayer injuries have long since occurred, and, after a refund is ordered, the BOC is no worse off than if it had never violated the rules. The relevant portion of MCI's prior Comments explaining these points in more detail is attached hereto as Exhibit D.

In the Computer III Remand Order, 6 FCC Rcd at 7596-97, ¶¶ 55-56, as well as in other proceedings addressing cost allocation rules in various contexts,^{85/} the Commission has presented price cap regulation as the magic bullet that will suppress the incentives to cross-subsidize to the point where such activities, at least at the interstate level, can be adequately controlled by means of cost allocation rules. As the recent audit findings indicate, however, that has not turned out to be the case. One must assume that the post-price cap cost shifting revealed by these audits was motivated, rather than purely random behavior. It follows that there is still a healthy drive to cross-subsidize among the BOCs even after the advent of price cap regulation. As MCI and other parties have explained for years, the sharing obligation and other rate-of-return aspects of price cap regulation create more than a sufficient incentive to continue cross subsidizing. Moreover, price cap regulation of interstate rates cannot have any impact on intrastate cross-subsidies, which

^{85/} Id. at ¶¶ 166-67.

are probably more significant for most ESPs.

Because the BOCs' incentives to inflate regulated costs continue, price cap regulation has not been the panacea for interstate cross subsidization that was once envisioned. The Commission therefore cannot rely on price cap regulation to supplement its cost separation rules. Moreover, the latter cannot be relied upon to substitute for structural separation, for the reasons explained in MCI's previous Comments and as evidenced by the recent audit findings.^{86/} Not only do those audits demonstrate that this Commission's system of price cap regulation has not diminished the BOCs' incentives to cross-subsidize at the interstate level (and could not have any impact on intrastate cross-subsidies), but they also demonstrate the BOCs' undiminished ability to do so.

All objective analyses concur that even with price cap regulation, the Commission's cost allocation oversight burden has grown, and "the staff resources allocated to this function have declined rather than increased ... [and] the number of FCC auditors remains inadequate to provide a positive assurance that

^{86/} It is also no answer that the audits themselves prove the effectiveness of the cost accounting rules. All of these audits have taken place long after the fact, after the damage has been done to competition and to ratepayers. Structural separation operates before the fact, preventing the injury altogether.

ratepayers are protected from cross-subsidization."^{87/} As the House Judiciary Committee noted:

Some have asserted that the current regulatory scheme limits the potential for anticompetitive conduct because of regulations such as price caps, automated reporting, non-discrimination reports, and State safeguards. To a large extent, the value of regulatory oversight depends upon enforcement resources which, as noted above, do not presently exist. The regulatory problem is exacerbated with regard to the RBOCs because they dominate entire geographic regions and overlap Federal and State regulatory jurisdictions. See, e.g., National Ass'n. of Regulatory Util. Comm'rs. Some RBOCs Are Not Cooperating With the NARUC's Joint State/Federal Audit Efforts (NARUC Summer Meeting, July 28, 1992) (detailing difficulties in coordinating overlapping State and Federal audits of the RBOCs.) In addition, it is widely understood that regulations are incapable of preventing anticompetitive conduct by monopoly utilities because of the inherent difficulty for regulators to second-guess a utility's subjective engineering and procurement judgment. See, e.g., 3 Phillip Areeda & Donald Turner, Antitrust Laws § 726, p. 219 (1978), ("the integrated utility can always argue that its product, though more expensive, is 'better'").^{88/}

Given the evident weaknesses of cost allocation rules as a safeguard against cross-subsidies, after so many years of tinkering by the Commission, it would be irrational to eliminate the structural separation requirement. That rule eliminates most of the problems of cross-subsidization by eliminating most joint and common costs and the opportunities for arbitrary misallocation of those costs. Structural separation also

^{87/} U.S. General Accounting Office, Telecommunications - FCC's Oversight Efforts to Control Cross-Subsidization, GAO/RCED-93-34, at 12 (Feb. 1993).

^{88/} Antitrust and Communications Report at 59 n.246.

highlights transactions between affiliates, thereby inhibiting cost shifting. Structural separation also provides state commissions with a powerful tool to control intrastate cross-subsidies, an especially difficult task when dealing with multi-state RBOCs. Given the Commission's chronically inadequate auditing and enforcement resources, the largely self-enforcing structural separation requirement is the only realistic safeguard against cross-subsidies.

CONCLUSION

It is clear that the case for eliminating structural separation is far weaker now than it was at the time of the Computer III Remand proceeding, just as it was far weaker then than it had been at the time of the original Computer III proceeding. ONA has now been held twice -- in California II and California III -- to constitute a significant retreat from the Commission's original promise of a fundamental unbundling, and thus an opening up, of the BOC network. As the Hatfield Report explains, the advanced technologies that were supposed to facilitate such unbundling are instead being used by the BOCs to tighten their grip on the local exchange bottleneck and close off access to competitive service providers. The paralysis of ONA leaves CEI and the other antidiscrimination rules as the main safeguard against access discrimination and other forms of anticompetitive conduct, and CEI has proven to be woefully inadequate to prevent such conduct in actual practice. The

EXHIBIT D

steps to strengthen the cost allocation rules.^{86/} The Commission concludes, in the alternative, that "[t]o the extent cost accounting safeguards may involve any diminution in protection against cross-subsidization, [relative to structural separation,] the danger of this is outweighed by the benefits of integration."^{87/}

As an introductory matter, the Commission's alternative conclusion clearly must be rejected. As explained in Part I of these comments, BOC provision of enhanced services will produce no significant public benefits. It is therefore impossible for such benefits to outweigh any "diminution in protection" resulting from elimination of structural separation. The Commission's attempt to reduce its regulatory safeguard burden by reliance on supposed benefits simply is not possible. Unless nonstructural safeguards can be shown to be at least as effective as structural separation in preventing cross-subsidies, therefore, the Commission cannot reasonably eliminate structural separation. As explained below, no such showing is possible.

2. Joint Cost Allocation Is Inherently Ineffective

The problem with reliance on the Commission's cost allocation and monitoring rules as a basis for eliminating structural separation is not so much that the rules need vast

^{86/} NPRM at ¶¶ 14-30.

^{87/} Id. at ¶ 32.

improvement, which they do, but that no cost allocation rules can effectively prevent cross-subsidies in the provision of integrated services. Accounting and other non-structural separation rules and policies fail to eliminate either the incentives or the opportunities to engage in cross-subsidization of nonregulated services with monopoly profits. Nor does attempting to "fix" the rules already in existence alter their basic ineffectiveness. The flaw with the Commission's reliance upon nonstructural requirements is that neither expending resources to improve their usefulness nor mandating greater compliance with them will alleviate the underlying reality that accounting safeguards are not capable of preventing cross-subsidization.

- Regardless of their form or strength, non-structural cost separations will not suffice because they fail to address three fundamental issues: (1) there is no accurate method for developing an allocator for jointly used resources; (2) telephone company control over allocation formulae and the internal data used to populate the formulae result in the distorted apportionment of costs; and (3) BOCs will continue to overproject their regulated use of joint investment and expenses, rendering incorrect any forward-based allocation.

a. There is No Accurate Method For Developing an Allocator For Jointly Used Equipment

Although BOC nonregulated operations have historically accounted for only a small portion of their total operations, the costs associated with these services are not insignificant. Projected 1990 nonregulated expenses for the BOCs are \$2.624 billion, or 4.72% of their total company expenses. If BOC nonregulated operations expand, MCI is concerned that the current problem of improper cost allocation will only magnify as the BOCs' nonregulated service costs grow.

The problems associated with joint use costing result, not necessarily from accounting abuses, but from the arbitrariness of the allocators used to divide joint costs, the BOCs' discretion to decide which of several allocators to use, and their ability to choose resources and technologies that evade the constraints of the costing process to their advantage. Simply put, there is no method that ensures correct cost apportionment of jointly used resources. On the surface, it might appear that standardization of allocators among the Tier I LECs would mitigate this problem, but there is no underlying "science" or economic theory upon which a particular standard can be chosen. Even readily trackable measures such as minutes or miles cannot accurately capture the cost causative effect that each BOC service will have on its choice of inputs or production techniques.

Further, even if a single method could be deemed the most

appropriate (though not accurately reflecting cost causation), the BOCs still retain discretion over both the compilation of the data used to calculate allocation formulae (such as usage) and the manner in which the joint services or investment are actually used. As long as the BOCs retain the incentive to engage in cross-subsidization, they will take advantage of any leeway in the implementation of cost allocation rules to benefit their unregulated ventures.

Investment in advancing technologies further increases the difficulty of achieving accurate allocations. In an integrated operation, carriers may select a technology that is more sophisticated or more extensive than is required of the regulated operation alone. The flexibility given the BOCs to choose the technology and the way it is employed can defeat even the most accurately designed accounting mechanism. For example, if the firm installs fiber primarily to offer enhanced or other nonregulated services, then the allocation of virtually any of those network reconfiguration costs to regulated narrowband basic services will be incorrect. Certainly, any allocation based on relative usage of these facilities -- given the predominance of regulated usage -- will not reflect cost causation, but will instead impose an unfair cost burden on the services that do not benefit from these large-scale investments.^{89/}

^{89/} Accordingly, the BOCs' MFJ argument that nonregulated services bear too much of the total costs can be ignored. The
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Ideally, a costing process should identify the additional research and development and implementation costs of building a network that can offer enhanced as well as basic services. Aside from any issue of the possible biasing of hardware design to favor nonregulated services, however, the design and costing of the associated software present a greater dilemma. Software development comprises a significant proportion of costs to the LECs of upgrading their networks, but it is often difficult to determine the actual cost of software due to discounting and other pricing practices that effectively bundle software costs with hardware costs. Under these circumstances, if a particular software package is acquired at the time of the initial purchase of a switch that is necessary only for future nonregulated services, it would be virtually impossible to develop a costing - model to reflect this underlying factor.

Even if the unbundled cost of software could be determined, the allocation of the cost of most software to individual services is virtually impossible. For example, the basic

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BOCs assume (BOC MFJ Reply at 58; Farmer Reply Aff., BOC MFJ Reply, at 14-15) that network investment is static and that the same facilities that are being jointly used would otherwise have been used only for regulated services. Under that assumption, the nonregulated service users are supposedly subsidizing the regulated service ratepayers by bearing some of the costs that the ratepayers otherwise would have borne entirely. In reality, however, more expensive facilities will be installed if joint use is intended, and the regulated ratepayers will end up bearing a disproportionate share of the additional cost, even though that additional cost was necessitated by anticipated nonregulated usage.

operating software of a digital central office serves many purposes, and it cannot be attributed solely either to regulated or nonregulated services. Moreover, even directly allocating the cost of specific applications software developed for nonregulated services to those services will not reflect the changes in operating system software or data base management system software that may be necessitated by the new applications software.

In sum, standardization of allocation models will not solve the joint use cost issues because there is no way to design the key element of such a model -- an allocator that accurately distinguishes between regulated and nonregulated costs. The more facilities that are jointly used for both regulated and enhanced services, the worse this problem will become.

b. The Commission's Cost Allocation Rules Are Ineffective When the BOCs Retain Control Over Both the Allocation Formula and the Internal Data Used to Apportion Joint Use Costs

As long as a carrier's judgment is so crucial to the costing process, the carrier cannot be held accountable to any objective standard. The discretion of the BOCs to both design the costing paradigm and input the data maximizes opportunities to direct the results of their usage allocations. Eliminating design flexibility (e.g., standardizing the allocation manuals) may reduce the problem, but no degree of monitoring (e.g., independent audits) or controls (e.g., the benchmark ratios of ARMIS) can remove the underlying incentive of the BOCs to cross-subsidize nonregulated services with regulated profits. As long

as this incentive exists, opportunities for the LECs to thwart the Commission's objectives will remain.

The costing safeguards that the Commission offers as a solution to this problem primarily serve as cost misallocation "detection devices," which function most effectively when applied to transactions that take place on an arm's-length basis. The rules governing transactions between affiliates establish explicit standards for exchanges between two discrete business entities, and carriers that fail to comply with these rules can, on occasion, be identified through the audit process. The current and proposed cost allocation rules, on the other hand, are not so clear, and it is more difficult to detect breaches of those rules (even with stricter audit standards), because they - are ambiguous and subject to inconsistent carrier interpretation.

The relative effectiveness of the Commission's rules when applied to affiliate transactions is illustrated by an audit of BellSouth's Cost Allocation Manual conducted by the Southern Task Force, a staff committee of the Southeastern Association of Regulatory Utility Commissions (SEARUC). The Audit Team reported that it believes that BellSouth's Cost Allocation Manual was "inconsistent with the requirements of Section 32.27(d) of the Uniform System of Accounts."^{82/} It reached this conclusion because BellSouth apparently improperly recorded on the books of

^{82/} SEARUC Southern Task Force BellSouth Audit at EX-7.

the regulated operating companies an affiliate transaction at a "negotiated contract" rate in excess of the actual cost of the service, resulting in a total overstatement of regulated costs by \$400 million since divestiture.^{20/}

Further, in an order adopted on October 3, 1990, the Commission accepted the Consent Decree negotiated in response to the NYNEX Telephone Companies' apparent violations of Commission rules governing affiliate transactions between the operating companies and NYNEX Material Enterprises Co. ("MECO").^{21/} Under the terms of the decree, NYNEX was required to reduce its interstate rates by \$35.5 million, reduce its capital accounts by \$32.6 million, adjust its 1990 Form M reports, and voluntarily contribute \$1.419 million to the U.S. Treasury. As is shown by - these examples, when carriers engage in flagrant violations of simple, clear rules, such as the affiliate transaction rules, it is far easier to take corrective action and assess penalties of the magnitude necessary to deter subsequent transgressions, than is the case when the infraction is of a more ambiguous nature.^{22/}

^{20/} Id. at EX-8.

^{21/} New York Telephone Co. and New England Tel. & Tel. Co., FCC 90-328 (released Oct. 4, 1990).

^{22/} Moreover, the relatively flagrant violations involving MECO were going on for a number of years, and were uncovered by private whistleblowers rather than the Commission's own investigation (see Boston Globe, December 22, 1988, at 1; MIS Week, January 9, 1989, at 7-8). The MECO Consent Decree thus
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The value of these rules and monitoring procedures is significantly reduced if the Commission fails to require structural separation of BOC regulated and enhanced service operations. Reliance upon a carrier's cost allocation manual to eliminate cross-subsidization is a particularly ineffective and inadequate solution when it is applied to the carrier's integrated operation because it is based predominately on judgment calls (both in designing the model and in evaluating the functional characteristics of the input cost data) and not on explicit, simple rules. It is difficult to identify, substantiate, and assess penalties for those rule infractions which fall into the "grey areas" that are endemic to both the development and application of carriers' cost allocation manuals.

An example of the problems associated with a system based on judgment involves the time reporting of a technician who both installs telephone lines (regulated) and repairs inside wiring (nonregulated). Only the individual performing the work function can attest to the correct allocation of the work effort. Even if the person is not aware of the financial impact of over-reporting regulated time, management may have provided subtle encouragement which might give the technician an incentive to incorrectly report the time required to perform the regulated task. Or, it

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hardly gives ratepayers a great deal of confidence that they will be protected, even where violations are relatively easy to detect.

simply may not be apparent to an individual how to appropriately allocate time. This could occur in an external relations function, where it might never be known whether the regulated or nonregulated sector benefitted from a particular encounter.

When these types of misallocations occur, there is little opportunity to detect or verify their existence, and therefore, it is unlikely the Commission will take punitive action against the carrier. It is next to impossible to judge the accuracy of an individual's time reporting, short of assigning another person full time to verify all reported activities, an impracticable and still judgment-based means of attempting to curb cross-subsidization. Further, even if a discrepancy were discovered, it is not likely to be an egregious rule violation, but rather a misinterpretation or "bending" of the rules.

c. The BOCs Will Continue to Overproject Their Regulated Use of Joint Investment and Expenses, Rendering Incorrect Any Forward-Based Allocation

The Commission should also retain its structural separation requirement because of the burden imposed on ratepayers due to the inaccuracies inherent in carrier forecasting of the relative regulated and nonregulated use of shared network facilities and resources. Even under price cap regulation, it is still in the BOCs' financial interest to overallocate costs to regulated operations because of the "sharing" obligation, as noted earlier. If a carrier overestimates regulated usage, it is required to

transfer the excess amount of investment from the regulated to the nonregulated books of account at the authorized interstate rate of return. If a carrier underallocates its regulated costs, on the other hand, no such adjustment mechanism exists. Once a carrier allocates costs to its nonregulated operation, therefore, it runs the risk of lower profitability, should nonregulated demand fail to materialize.

To avoid such an outcome, a carrier may choose to simply overforecast regulated usage, and later, if necessary, make the penalty-free adjustment. The resulting overassignment of costs to the regulated side reduces the carrier's price cap sharing obligation, thus ultimately forcing regulated ratepayers to finance investment that actually benefits nonregulated services.²³

Thus, overall, the BOCs retain the flexibility to free their nonregulated services of any of the normal business risks of making long term competitive investments. If a BOC were to overinvest in facilities used partly for competitive services, or if demand for a competitive service fails to materialize, these BOC operations do not face risks commensurate with those encountered by similar non-BOC affiliated ventures. To the

²³ Similarly, if a carrier were struggling to achieve a minimal earned return, it might be encouraged to load costs onto regulated services because the lower adjustment formula mark guarantees a level of profitability that is not guaranteed for competitive services.

extent that such investments can be allocated to regulated services, the nonregulated business unit is not burdened with the total risk associated with that investment. Structural separation must be maintained to reduce the ratepayers' exposure to the financial burden and risks associated with incorrectly allocated unregulated costs.^{24/}

^{24/} The BOCs may argue that the exogenous treatment of reallocations from regulated to nonregulated costs under price caps (see LEC Price Cap Order at ¶¶ 171-72) will serve as an effective check on the tendency to overallocate costs to regulated services. At first glance, the "penalty," in the form of a PCI reduction, of having to correct for such overallocations under price caps would appear to deter such overallocations.

In fact, however, the forecasting methods used by the BOCs continue to provide loopholes which a creative BOC will be able to use to ensure that such a costly reallocation can be avoided through adept forecasting. As BOCs make new investments, annual forecasts of relative use are made to add these investments to the existing cost pools. At the end of each year, forecasted use is compared to actual use for each pool. On a going-forward basis, the forecasted usage for the cost pool equals the weighted sum of the forecasts for each year's addition to the pool. At no point, however, is any forecast of the usage of a single year's investment compared to the actual usage of that particular investment. Rather, the comparisons are made between usage and projections for all investments added to the cost pool from the time the nonregulated services are first offered until an investment is fully depreciated. Accurate forecasting, therefore, is never required on an individual investment basis, creating an opportunity for the BOCs to adjust for previous forecasts instead of making downward rate adjustments.

As long as relative use projections are adjusted every year, as new investments are added to the pool, BOCs can always skew usage projections for new investments to offset previous regulated overforecasting. Thus, as actual regulated usage of existing investment falls short of previous projections, the regulated usage of new investment can be similarly overprojected so that overall, projected regulated usage appears to be in line with actual regulated usage, thereby avoiding the need for reallocation from regulated to nonregulated costs.

d. Joint Cost Rules Cannot Prevent
Misallocations of Personnel Costs

Joint cost rules are also useless in allocating one of the most important investments in the information industry, namely human costs. Nothing in the Commission's joint cost rules, or in any conceivable set of rules, can control the inherent subsidizing of enhanced services that occurs when regulated service employees develop a network capability that will be useful for the BOC's enhanced services, especially one that will not be as useful for other ESPs' services. The network capability and the BOC employees are part of the regulated system, so their costs are attributed entirely to regulated services. In fact, however, it is the enhanced services that have benefitted, while bearing none of those costs. An even more obvious, but still unrecognized, cross-subsidy occurs when an employee is trained by a BOC and then transferred to the enhanced service operations. His or her salary and other overhead expenses may be attributed to the enhanced services from then on, but the value of the training invested by the ratepayers is never recaptured.^{25/}

3. Cost Accounting Regulation Operates Only After the Fact

In those limited situations where cost accounting regulation might work, it still fails because it operates only after the

^{25/} Such transfers can still take place under structural separation, but they at least are more visible in that case.

fact. Until the time that the Commission's overstrained audit resources can be brought to bear on a cost violation, the BOC is able to overcharge its regulated ratepayers and undercharge its enhanced service customers. It can thus unfairly gain market share at the expense of independent, lower-cost ESPs, thereby possibly damaging competition in enhanced services. Once the Commission catches up with the violator, the economic damage has been done and may not be remediable. Even with the increased penalties described in footnote 61 of the NPRM, a BOC will still have an economic incentive to misallocate costs. The penalties, if they are assessed, are still trivial compared with the tremendous multi-million dollar advantages that can be secured through cost misallocations of only hundredths of one percent of total costs. Penalties are still just another cost of doing business for the BOCs, leaving their incentives to shift costs and cross-subsidize unaffected.

4. The Five Proposals in the NPRM Add Nothing of Significance to This Proceeding

Finally, the five new proposals in the NPRM -- although positive steps in themselves -- must be discounted in any cost-benefit analysis of the substitutability of nonstructural regulations for structural separation. The first proposal is nothing new, but rather calls for continued nonregulated treatment for enhanced services.^{26/} Obviously, any joint cost

^{26/} NPRM at ¶ 27.



*An Audit Report Presented
to the
NARUC Committee on Finance and Technology*

*An Audit of the Affiliate
Interests of the
Pacific Telesis Group*

*Prepared by
The Staff of the
California Public Utilities Commission*

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San Diego, California
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An Audit of the Affiliate interests of the Pacific Telesis Group

EXECUTIVE SUMMARY

On November 13, 1991, the National Association of Regulatory Commissioners adopted Resolution Number 8 calling for an Audit of the Seven Regional Bell Operating Companies' (RBOCs) affiliated transactions. This resolution was sponsored by the Committee on Finance & Technology and expressed many of the concerns that had been the subject of ongoing informal discussions. In summary these concerns are:

1. the potential for cross-subsidizations between regulated and non-regulated RBOC businesses;
2. the relative economy and efficiency with which products and services are provided between the operating companies and their parent companies and/or unregulated affiliates;
3. the effectiveness and adequacy of present non-structural safeguards;
4. the need for a good understanding of current holding company structures, parent-subsidiary relationships and the affiliated inter-company relationships; and
5. the lengths of time since RBOC business direction and activities have been reviewed.

It was further determined that good regulatory policy would support the idea of a periodic review in a comprehensive manner. Such an audit would promote public confidence in the regulatory process.

During the early months of 1992, the audit team started its planning for the audit of the affiliate interests of the Pacific Telesis Group. Initially, the team consisted of the audit manager and five team members. Accordingly, as the audit plan was prepared, all six of the specified areas for examination were included in the scope with the hope of gaining at least two more team members. However, over time we were unable to maintain this staffing level. Over the course of the audit, the audit team kept on average a team level of approximately two full time and one part time participants. Consequently, the scope had to be eventually trimmed to cover only three of the six audit areas. The three areas chosen for the audit are:

- Research organizations,
- Enhanced service organizations,
- Yellow page organizations.

Research Organizations - In addition to a general review, the NARUC Audit Team selected for a detailed review two of the principal areas of research to which Pacific Bell has made major commitments. Those areas are Personal Communications Services and Broadband Integrated Digital Network. The findings and conclusions resulting from this audit of Pacific Telesis research organizations and activities in many respects mirror those of previous and current audits. The same concerns regarding cross-subsidization of affiliates, potentially competitive and competitive products and services are also present in this audit. Regulatory agencies' heavy reliance on non-structure safeguards, such as cost allocation systems and project tracking systems may be misplaced. These systems and procedures appear to be inadequate to ensure that cross-subsidizations will not occur. The concern is that these safeguards may be creating the perverse effect of encouraging cross-subsidizations.

Research and development expense, as defined and tracked by Pacific Bell, is historically a relatively small amount. Yet, billions of dollars are required to build or modify the necessary network infrastructure so that these new information age products and services being developed at the research laboratories can be offered. There is not a bright line between what should be chargeable to the shareholders vis-a-vis the ratepayers. This artificial line is especially oblique with respect to the accounting for new major platform projects between what should be accounted for above and below-the-line. The present regulatory scheme provides the utilities with the incentive and the means to charge the